Set	Items	Description
S1	643	(DEBT (4W) SECURIT? (4W) BACKED) AND PY<2000
S2	52	S1 AND LOAN? AND SELL? AND CREAT? AND INSURANCE
S3	0	S1 AND LOAN? AND SELL? AND CREAT? AND TAX()ACCOUNT?
S4	0	S1 AND LOAN? AND SELL? AND CREAT? AND REFUNDABLE (4W)ACCOU-NT?
S5	68	(DEBT (4W) SECURIT? (4W) BACKED) AND CANAD? AND PY<2000
S6	45	2 AND S5
S7	8	S6 AND RETIREMENT
S8	264	S1 AND (DEBT (4W) (SECURIT? (2W) BACKED))
S9	20	S8 AND LOAN? AND SELL? AND CREAT? AND INSURANCE
S10	4	S9 NOT MORTGAGE

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10/K,9/1 (Item 1 from file: 15)
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Leveraged investing may have taken a public lashing last summer thanks to the dramatic near-collapse of the gunslinging hedge fund Long-Term Capital Management. But the main attraction of leverage -- enhanced returns --persists, and investors are pouring into the newest structures designed to maximize yield, while containing, as best they can, risk.

The vehicle of choice: collateralized **debt** obligations. Issuance of these **securities** , which are **backed** by pools of junk bonds or bank **loans** , has simply exploded. In 1995 only $1 billion in rated CDOs were offered. Last year $82 billion were rated and snapped up by gorging investors. And Moody's Investors Service expects issuance to grow by 20 to 30 percent this year.

CDO is a relatively new term for an evolving investment class. Essentially a type of asset-backed security, CDOs pool their collateral in a trust that issues several tranches of securities with tiered seniority, from a top level of highly rated senior debt to a bottom portion of unrated equity, which is the first to lose value if any of the underlying collateral stops paying for any reason. Unlike most other assetbacked securities, CDOs use

high-yielding collateral such as junk bonds, leveraged **loans** and emerging-markets bonds to goose their returns. A CDO tranche can yield up to 100 basis points more than comparably rated corporate bonds. Issuers of the securities - who package and manage the underlying portfolio -- boost yields by buying the underlying collateral on margin.

Such yields don't come without risks, of course, which vary depending on the tranche. The top tranche often carries bond **insurance** and may sport a triple-A rating. Middle tranches are junk-rated. Though none of these midtiers have suffered a default, Moody's downgraded tranches of 20 CDOs in 1998. Almost all of these were CDOs backed by Japanese bank **loans** , but two issues from Credit Suisse First Boston and Credit Suisse Financial Products - the York Funding and Triangle Funding CDOs - received lower ratings because of the bank's own downgrade. (The collateral in each issue included credit-linked notes issued by CSFB and CSFP.) Last year Standard & Poor's did not downgrade any of the CDO tranches it rates, because they all had bond **insurance** .

Despite the risks, investors love the yield boost that CDOs offer. "Typically, we like single-A, triple-B, sometimes double-B tranches," says Keith Koh, an investment manager with Principal Capital Management, which has bought CDOs since the market began a decade ago. "We did a study going back to 1994 and it shows that double-B tranches definitely performed 100 basis points over similarly rated corporate bonds." Single-A tranches typically pay 30 to 40 basis points over corporates, he adds.

Money managers can also take advantage of an arbitrage opportunity by structuring CDOs and **selling** the tranches to other investors. Often managers buy bonds and **loans** worth ten times their initial equity investment, borrowing against the collateral pool in a transaction resembling a repurchase agreement. Investors receive the difference between the leveraged collateral payout and the CDO's cost of funding. Even as the debt markets have recovered this year, the spread between B-rated instruments (the typical collateral for a CDO) and double-A corporate debt (comparably rated to a CDO's senior tranche) has reached as much as 500 basis points. That wide spread makes it very easy to effect the arbitrage.

Pacific Investment Management Co. has structured seven CDOs worth a total of nearly $3 billion in the past several years and is working on a new one. The firm earns management fees of about 40 basis points for running the CDO portfolio and sometimes reaps a performance fee of 20 basis points linked to equity holders' returns as well. Pimco keeps its CDOs separate from the bond portfolios it manages for clients, but the firm's huge presence in the bond market puts it in an ideal position to buy bonds and **loans** for CDO collateral.

Money managers like Pimco typically structure CDOs with the help of an investment bank, which underwrites the issue and **sells** the tranches. Buyers typically include endowments, **insurance** companies, alternative asset managers, private clients and, sometimes, other fixed-income managers that are looking for diversification. "There's a much greater acceptance of financial engineering," comments Pimco high-yield product manager David Hinman. "People are more comfortable with synthetic structures."

The fat yield on the investment-grade tranches helps, too. Money market funds and European banks tend to be big buyers. Endowments often select mezzanine and equity pieces; as buy-and-hold investors they can capture the illiquidity premium priced into the less creditworthy tranches. Funds-of-funds and alternative asset management groups also tend to buy the mezzanine and equity pieces.

The CDO market got under way in the late 1980s with the first collateralized bond obligations, which were sold by troubled thrifts to reduce their junk bond exposure. The collapse of the junk bond market in the early 1990s caused CBO issuance to dwindle. Then, in 1996, National Westminster Bank applied the idea of securitization to its **loan** portfolio, packaging $5 billion in a collateralized **loan** obligation that it sold to a wide range of international investors.

The move freed up regulatory capital that had been committed to backing the **loans** ; investors snapped up the securities, which had ratings varying from double-A to triple-B and yielded attractive rates of 8 to 65 basis points over LIBOR.

Even as CLO issues boomed, highyield debt began to return to favor, spurring the issuance of new CBOs, including many that pooled emergingmarkets bonds. Today the CBO and CLO markets are converging, with managers like Pimco mixing bonds and **loans** , and even emerging-markets debt, in the same structures.

In fact, the market is grappling to some extent with terminology. Most market participants, including Moody's, use CDO as an umbrella term for all these securities. S&P considers CBOs, CLOs and CDOs to be separate products; it thinks of CDOs as hybrids that include both bonds and **loans** .

In any case, CDOs continue to evolve, as money managers fiddle with the best mix of collateral to contend with the three main pitfalls for a portfolio of bonds: default risk, liquidity risk and event risk.
Pimco's Hinman argues that it is possible to eliminate the latter two risks by managing CDOs passively, holding **loans** and securities to maturity.

Managing default risk is trickier but that's where the right mix of bonds and bank **loans** comes into play. Bank **loans** , for instance, are safer instruments than junk bonds because they have a higher position in the capital structure of companies. By putting a large proportion of **loans** in the CDO collateral pool, the manager can limit the default risk. Hinman reckons the optimal mix of a CDO today is 70 percent bank **loans** , 20 percent bonds and 5 percent emergingmarkets bonds. Five percent is usually in cash, he says. Just a few years ago, most CDOs had a much higher ratio of bonds to bank **loans** --Hinman's first CDO, in 1996, consisted of 80 percent junk bonds, 10 percent bank **loans** and 10 percent emerging-markets bonds.

Why not **create** funds that are just filled with bank **loans** ? Because junk juices the yield. "The most bang for your buck comes from high-yield bonds," says Anthony Clemente, a senior portfolio manager at Invesco, which plans to launch two new CDOs this year. He points out that bank **loans** , unlike junk bonds, generally don't trade higher than par. "There are certain industry categories, like telecom, oil and gas and some cyclicals, where there is really no upside for bank debt, while there is significant downside." With junk bonds, explains Clemente, "the spread differential is significant." The bonds, he notes, might trade up to 9 points over par. Invesco, notably, actively manages its CDOs, buying and **selling** collateral to achieve the best return. Pimco prefers a buy-and-hold strategy, restocking portfolios when **loans** mature and occasionally **selling** securities to avoid default risk.

Bank **loans** do have drawbacks, though, including a thin secondary market. Because the easiest way to invest in bank **loans** is through the primary market, CDO managers are forced to buy into the prevailing industry trend.

Recent bank lending, for instance, has concentrated heavily on the telecommunications industry. That means that CDO managers have little choice but to buy into telecom issues. "What you put in the portfolio is partially driven by availability," says Hinman. "The bank **loan** market is a new-issue market."

Some CDO managers, including Pimco, have used emerging-markets bonds to turbocharge their yield. But after last fall's bond market turmoil, rating agencies view emerging-markets far less favorably. "If you put too many emerging-markets bonds in, the stress tests look horrible," Hinman explains.
S&P structured-finance analyst David Tesher still paints a relatively reassuring picture, however, pointing out that even during the junk bond market's worst days, CBOs performed relatively well. "If you look back to the early '90s, there were some CBOs that had problems," he recalls. "There were some that generated very poor returns for the equity investors." But, he adds, "I know of no structures where senior note holders have taken a loss." it

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10/K,9/1 (Item 1 from file: 15)
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Word Count: 4198
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INTRODUCTION

As Fernando Collor de Mello's inauguration as president on March 15 draws near, business anxiety has mounted over what economic policy measures he is likely to take and how they will affect each sector. The anxiety has been aggravated by Collor's veiled threats of coercive measures to enforce price controls, and persistent uncertainty with just three weeks to the inauguration over the critical choice to head the reorganized and strengthened Ministry of the Economy. As of February 21, Collor's top economic adviser Zelia Cardoso de Mello -- the architect of the economic program now under review by the president-elect -- still appeared the most probable choice, though a continued surge in inflation to inauguration day could weaken her position. A decision by Collor to adopt a more aggressive anti-inflation shock along the lines proposed by banker/economist Daniel Dantas -- still touted as a possible economic minister or CB president -- would spell a defeat for Cardoso de Mello's consistent espousal of a more gradualist approach, anc could force her off the economic team (see ECONOMIC DEVELOPMENTS section).

The business community's skepticism over public commitments by both Cardoso and Collor to avoid price controls has been dramatically underscored by the flurry of price markups in recent weeks. Private sector leaders generally have indicated that they would be more reassured with the selection of an experienced and conservative economic minister such as Mario Henrique Simonsen or Affonso Celso Pastore -- or even Jose Serra, a PSDB congressman and economist who is well connected with financial and industrial groups in Rio and Sao Paulo. By contrast, Cardoso de Mello is largely an unknown in economic policy -- as is the president-elect.

It should be recognized, however, that Collor's middle- and long-range program for economic restructuring tilts heavily toward expansion of the private sector, and scaleback of the public sector role in industry and the general economy. That point was reaffirmed with the president-elect's appointment of former Petrobras and Embraer head Ozires Silva -- a forthright proponent of privatization -- as head of the powerful new Ministry of Infrastructure.

In part, Collor has run into conflict with domestic industry because he threatens to dismantle the elaborate system of subsidies, tax breaks and tariff protection that has long insulated many companies from competition both at home and abroad. One of the first targets of Collor's campaign to encourage competition will be the monopolies and "oligopolies," or cartels, that still control key domestic markets.

The first order of business is the battle against inflation -- and as inflation moves higher, the prospect heightens that Collor will embrace a more radical shock plan to slash inflation. The business community is

clearly concerned over the president-elect's indication that "those who have profited most from inflation will make the biggest sacrifice." The obvious fear is that Collor will make big business and big banks the primary scapegoats in the war on inflation, in an effort to mobilize popular and legislative support behind his economic stabilization program. Hence the fear of a price freeze at the outset of the new administration persists.

Nor do private sector leaders show any more confidence in the new administration's capacity to ease inflation lower through the more gradualist approach proposed by Cardoso de Mello. The fear is that such a strategy will be fatally undermined by populist efforts to prevent layoffs and placate restive public employee associations and labor unions. That scenario would point to continued high inflation, and could pave the way to a belated attempt at a price freeze.

Brazil Service looks for Collor's anti-inflation program to take shape in a series executive decrees, policy actions and legislative proposals in the first months of the new adminisitration. The immediate task of curbing the price spiral, moreover, will be placed within the broader context of a program for fiscal and financial reform, trade liberalization, deregulation and privatization. This SPOTLIGHT report sets out the most likely elements of this program, and assesses the new president's prospects for gaining critical support from Congress, labor and business to implement the key measures proposed. We also take a preliminary look at how these proposals will influence the new administration's policy on renegotiation of the foreign debt.

THE FISCAL SHOCK

Zelia Cardoso de Mello, who spearheaded drafting of the economic stabilization package now under final review, has defined it as a proposal for a "fiscal shock" to brake the present price spiral and bring monthly inflation back down to single digits by June. A key element of the program is a sharp reduction in federal government spending and a significant increase in the government's revenue intake. That would diminish the need to print money or issue ever higher amounts of Treasury paper to cover the federal deficit -- a vicious circle that has contributed to the present inflation crisis. Cardoso de Mello has even floated the possibility of achieving a small federal surplus this year, which would mark a dramatic reversal from a 1989 deficit of some US$24.5 billion, or 7% of GDP.

There is little doubt that Collor intends to turn the federal government bureaucracy inside-out by slashing parastatal payrolls and federal spending and putting scores of real estate tracts now owned by the government up for sale. The Silva appointment also has underscored his determination to move forward aggressively on privatization of parastatal companies. But since such measures take time to implement -- and at least some will require congressional review -- they will have little practical impact on the deficit or inflation during the critical first 100 days of the new administration. At best, the will serve to establish Collor's credibility and to set the stage for an accord with the IMF and the banks.

A quicker route to fiscal solvency would be to stretch out the federal debt profile on the open market. Service of the federal domestic debt currently sops up as much as all other administrative spending combined. Collor and Cardoso have rejected the option of a unilateral moratorium on domestic debt service, but indicated that they aim to negotiate an exchange of short-term government debt for new debt at longer maturities. So far, they have been careful not to reveal details on how negotiations would proceed, nor who would bear the brunt of the loss -- and how much.

Many believe that such negotiations have already taken place, discreetly, with the financial sector, with the results to be announced on March 15. There have been some signs that the banks would voluntarily take substantial losses in a debt stretch-out. Jose Eduardo Andrade Vieira, president of the Bamerindus banking conglomerate -- Brazil's third largest private financial institution and among the top three government paper

dealers on the open market -- has indicated that the banks are prepared to take losses in order to right the economy. In a parallel move, the possibility has been raised that present short-term fixed-rate funds would be moved to maturities of one to three months, comparable to cadernetas.

What the banking industry fears is a more radical shock that would involve a far more dramatic loss, as through a temporary freeze on overnight market operations. The proposal advanced by Daniel Dantas would have achieved such a shock through an effective freeze on overnight market activity for one to two weeks, coupled with an immediate one-shot elimination of indexation for financial instruments. Collor rejected the Dantas proposal in January, and still appears unlikely to take such a radical step -- but recent bank criticism of the president-elect suggests a lingering fear that he might yet move in that direction.

On the revenue side, Collor is weighing a proposal to impose a system of compulsory deposits for gold and other financial operations where the government aims to curb speculation. A broader response to the fiscal shortfall through proposal of a range of new tax increases is also expected, but the 1988 constitution would push back implementation of any tax hikes approved to 1991. The constitution also limited the federal government's tax powers by shifting a greater share of collection and expenditure authority to the municipal and state levels. However, Brazil Service has learned from Collor team sources that a special tax task force has turned up numerous loopholes in the constitutional limitations on tax powers --and at least some should allow the administration to move more quickly on implementation of new tax measures. Specifically, the government appears to have the authority to order immediate implementation of taxes on industrial production, exports and imports, and financial, credit, **insurance** and equity operations.

Cardoso de Mello has recommended against sharply increasing the industrial production tax (IPI) for fear that it would undermine the anti-inflation program. Exports have already been heavily penalized by a hike this year in income taxes (from 6% to 16%) on exporter profits, coupled with the termination of BEFIEX advantages applied to auto exports. And the new administration will want to use import liberalization to undermine domestic oligopolies, stimulate domestic competition and bolster the anti-inflation effort.

This leaves the financial sector as the best candidate for new taxes that could immediately fatten the national treasury. The IOF (tax on financial operations) is relatively modest, and could be increased significantly. The current absence of taxes on stock market and futures operations, and the relatively small 1% tax on gold operations, leaves an obvious opportunity for imposition of new taxes in these areas. Taxes on inter-bank dealings are another possibility.

More aggressive tax collection is another route to higher revenues that the Collor team has already aired. Tax avoidance and tax evasion are deeply ingrained in the Brazilian system; many large companies flagrantly dodge tax obligations, and many more miss tax deadlines. Shortly after the inauguration, Collor appears certain to order launch of prosecutions against several alleged tax evaders as an example to the business community. What is less certain is whether this crackdown will bring in more money -- or simply encourage more clever evasion.

FREEZE SPECULATION

Uncertainty about whether the new government would impose another price and wage freeze has itself been a major factor stoking inflation, as businesses have jacked up prices in anticipation of controls. Collor has consistently rejected the option of a freeze as in direct conflict with his general thrust of reduced government interference, freer markets and encouragement of competition. But with inflation above 70% monthly and still rising, the freeze option cannot be ruled out.

A price freeze along the traditional lines set by the Cruzado, Bresser and Summer plans -- each of which ended in a renewed inflation surge -- is

probably not in the cards. Instead, the Collor team is weighing strong controls for basic items produced by the oligopolies that control key domestic markets. These controls would probably be applied at the production, not the retail level. A new system of controls would most likely be implemented by the existing Interministerial Price Committee (CIP), whose mission would be scaled down to control of prices in oligopolistic and monopolistic industries.

Though the oligopolies have no doubt been a factor in inflation, their role has been significantly exaggerated as a justification for selective reintroduction of price controls. A true free-market economist such as Pastore would rather risk the distortions of the oligopolies and do away with the CIP and other control mechanisms that have damaged industtry's capacity to function normally and competitively. The very survival of the CIP in the new administration would pose a significant threat to business confidence in the anti-inflation program.

FX POLICY

That the new economic team will devalue the cruzado is virtually a sure bet. The question is the size of the devaluation to be announced on March 15, with 20-30% considered the most probable range. As discussed in the SPOTLIGHT report of our previous issue (see X-3), the new administration will need to give exports a vigorous push since a healthy trade surplus is vital to realization of its economic plans. Specifically, higher exports are essential to sustain the planned increase in imports, which is expected to stimulate competition and hold down prices in the domestic market. Hard-currency earnings from exports are especially needed to finance the import of new technology and capital goods for modernization of domestic industry. But the growing overvaluation of the official new cruzado rate has cut steadily into the competitiveness of Brazilian exports abroad.

In addition, the Collor administration will probably address the larger issue of FX controls and multiple exchange rates at some point. Like the limited price controls now under discussion, FX controls **create** pressures that prevent firms from operating in a normal competitive fashion. Firms worried about artificial manipulation of FX by the government almost invariably try to protect themselves by rushing or delaying imports or exports, and engaging in the common practices of over-invoicing imports and under-invoicing exports.

Collor previously has indicated that he would like to eliminate multiple FX rates. Though no one expects him to float the cruzado and unify FX rates immediately, the March 15 reforms may provide a hint whether policy could eventually move in that direction. If the package chops away at the forest of red tape now hamstringing importers and exporters, this would be one sign Collor intends to put trade on a more realistic footing.

UTILITY RATES

The Sarney administration has done its successor one big favor. In the past three months, it has raised public utility rates and parastatal product prices well above inflation, bringing them to realistic levels and making most of these companies self-sustaining for the first time in five years. This is one less unpalatable task that the Collor government will have to carry out.

However, we can expect a good many dirty tricks by parastatal bureaucrats in pricing utility and product rates in an attempt to sabotage the Collor government, much as they did during the Sarney administration. In one egregious example, the telephone monopoly decreed an absurd 500% rate increase in order to embarrass the minister of communications. There are indications that the Collor team is aware of this danger and will act rapidly to dismantle the network of bureaucratic saboteurs.

The incoming team and the entrenched interests in the parastatals are expected to lock horns early on. In fact, the Collor team will immediately have to face and deal decisively with the bureaucratically manufactured alcohol fuel shortage, which will be at its peak in mid-March. Unless the

incoming team presents a tough and definitive solution to the alcohol crisis as soon as it takes office, it could suffer a swift erosion of public confidence at a time when it most desperately needs the public's support. An immediate dismissal of Petrobras directors involved in the alcohol fuel crisis would be one way to demonstrate that Collor is firmly in charge.

DEINDEXATION

The new government is broadly committed to dismantling of the present comprehensive system for indexation of the Brazilian economy. The question of how quickly indexation is phased out will depend on who holds the economic portfolio. Zelia Cardoso de Mello has indicated that she will move gradually on this score, rather than the swift and immediate dismantling of indexation proposed by Dantas and Simonsen. The former strategy would cause less social pain and limit the recessionary impact -- but it could prove too gradual to have a significant and lasting impact on inflation.

Zelia's gradualist approach, which would involve pre-indexing prices and wages in descending steps from one month to the next, is favored by the moderate left of the PSDB and PMDB, as well as organized labor. For gradualism to work, it would require broad cooperation from opposition parties in Congress and business and labor participants in negotiations with the Collor government. The strategy would be to reactivate the business sectoral committees and expand them to include representatives from labor, which would have to be willing to absorb some of the initial real wage losses.

PRIVATIZATION

Collor and his team appear to have decided to focus the privatization program initially on those **selloffs** that do not require specific legislative approval. Opposition in Congress to privatization remains broad, and legislators remain vulnerable to pressure from interest groups representing employees and management of the various parastatals. In opinion polls, the majority of the Brazilian public has shown itself consistently opposed to privatization of most basic public services. Opponents of privatization are already mobilizing parastatal employees to stand firm against the effort.

Considering this level of opposition, Collor and his newly appointed Infrastructure Minister Ozires Silva will concentrate at first on privatizations that do not depend on congressional approval. According to constitutional specialists, this applies to about 30% of the present parastatals. Collor's initial targets will be the firms taken over by the government and put under the wing of the government development bank, BNDES. Since these companies were not **created** by law, their privatization can be mandated by the executive branch.

President Jose Sarney was slow to reprivatize these firms because he feared the reaction of employees, unions and leftist parties. Collor is less likely to heed resistance from these quarters. For example, he will move ahead quickly with the privatization of Mafersa, the rail equipment company that was about to be put up for sale last year, an action that was stopped under pressure from the PT. There are also a number of small- and medium-sized steel mills, petrochemical operations and fertilizer companies ready for privatization, which will be achieved mainly through the stock market.

The Collor government will also encourage initiatives by private capital in some areas that had been the domain of state companies, such as electric power generation and flat-steel mills. It is also possible that the Japanese stock share of the Usiminas steel mill will be pushed back up to 49%, from the present 5%. An agreement to this effect may have been reached during Collor's visit to Tokyo last month.

In a second stage, Collor will attempt to privatize other companies not **created** by law, perhaps via a global privatization bill that the president will announce on March 15 and send to Congress for approval. This bill would give the president broad privatization powers within established

limits and would obviate the need for approval by Congress of specific privatizations.

THE FOREIGN DEBT

Collor has publicly promised to present a proposal for renegotiation of Brazil's foreign debt on March 15, and in the first week of his government will send a team to New York and Washington to begin discussions with commercial bank creditors. He also is expected to bring debt service current on obligations to the multilaterals and Paris Club, if the outgoing administration has not already done so.

His specific plans for renegotiation of the commercial bank debt are one of the best-kept secrets so far. There is an outside chance that Collor will make a symbolic payment of interest, but he will certainly not attempt immediately to pay off arrears expected to reach some US$5 billion by March 15. Most likely, the new president will offer to capitalize debt service in arrears or commence negotiations on a scheme for securitization, perhaps through exchange for exit bonds.

The broader focus will be a global debt reduction scheme including a menu of debt reduction options, including debt-equity conversion and exchange of old **debt** for new **securities** **backed** by US Treasury zero coupons. There are strong indications Washington has assured Collor that he will get help from the US Treasury in the form of a bridge **loan** , which would be the first step toward the negotiation of a debt solution similar to that recently agreed between the banks and Mexico.

Despite resistance from some commercial banks, Brazil appears to have at least one influential ally in Citicorp chief John Reed. The goal often mentioned by Collor would be to bring down annual debt service to half of the approximately US$8 billion in annual debt service currently paid by Brazil on the bank debt. But even if the plan were to reduce debt service by one third, it would be a victory for the new president. While the bank negotiations proceed, Collor is counting on IMF approval of his March 15 economic plan to clear the way for release of large amounts of credit in the pipeline from multilateral and Eximbank sources. The release of such export credits is important to financing the imports that Collor is counting on to spur local competitiveness -- a key weapon against inflation. In this context, Spain may be among the first to come to Collor's assistance. Prime Minister Felipe Gonzalez has promised US$5 billion in trade credits -- considerably more than Japanese, West Germany and US eximbanks are currenttly offering to advance to Brazil.

CONCLUSION

The immediate fallout of the Collor economic plan, if it goes according to the outline sketched above, is likely to be recession as federal employee ranks are thinned, parastatal budgets slashed, taxes on financial operations increased, and tax collection tightened. On the upside, the economy will get a boost from the redirection of investment funds away from inventories and the overnight market, and from the influx of foreign investment encouraged by debt conversion and other favorable policies -- though the full positive impact will not be felt until the second half of the year.

Thus, the first few months of the Collor administration will be marked by a short-lived recession with higher unemployment and a reduction of consumer spending. The recessionary impact of the stabilization program should ease inflationary pressures. But if organized labor is not brought into the price-control process, the government's resolve will be tested early by a wave of strikes.

The prospects for legislative approval of Collor's economic stabilization measures have greatly improved in the past several weeks. The president-elect's round-the-world tour garnered more publicity and support at home than abroad. Private polls indicate that Collor now has the support of 70% of the population --substantial backing for the measures the new president will take on March 15.

The rapid deterioration of the economic situation in February, with

inflation soaring to over 70% per month, may also work in Collor's favor. Some of the new president's advisors quietly espouse the philosophy of "the worse, the better" when Collor takes office, with the idea that it will enhance his capacity to summon congressional support for his measures. The negotiations of new Justice Minister Bernardo Cabral and Senate leader Carlos Chiarelli with opposition parties and leaders have been largely successful, providing reasonable assurance that most of Collor's proposals will pass congressional muster.

However, the new president is unlikely to get all that he asks for. Collor had wanted Congress to award him emergency powers to put many of his more urgently needed measures into effect. But even congressional conservatives and moderates are hesitant to give Collor carte blanche on his plans for privatization and restructuring of the bureaucracy. The executive is likely to get enthusiastic backing for measures that penalize the financial sector, but in an election year, legislators are steering clear of delicate issues such as privatization and firings.

The success of the larger Collor program depends heavily on how quickly and effectively the March 15 anti-inflation measures take hold. Collor must make immediate progress in reducing inflation within the first 30 days of his adminisitration -- ingrained expectations of high inflation must be broken immediately for there to be any hope of further gains.

If the plan survives this initial test, Collor may be able to get the Brazilian economy moving again. Though the program's details are still not complete, analysts give Collor's more comprehensive approach a better chance than the series of price freezes that Sarney has depended on for the past five years.

The risk is that Collor will succumb to the temptation of using the business and banking sectors as scapegoats in order to mobilize popular and political support for his agenda. Such a strategy could slow the pace of local investment and discourage foreign investment at a time when the East European alternative looks more and more attractive. A timid approach to freeing the FX system and slow progress on privatization would leave these two longstanding issues unresolved. And ambivalence about cutting away the fat from the federal payrolls would **create** doubts in the business community about the president's promise that the government would take its share of the pain in order to reduce the deficit, and consequently inflation.

On the other hand, it is quite possible that Collor may move daringly in some of these areas. For example, he has been told by his legal advisers that he can fire up to 25% of the federal employees without permission from Congress and within present constitutional limitations. If he takes advantage of this

opening, he stands a better chance of motivating private sector business to tighten its own belt and accept the sacrifices it is being asked to shoulder.

Another confidence-building measure would be the offer on March 15 of a reasonable solution to the debt problem. This would do more than anything else to renew foreign investor interest in the country. Even with its obvious benefits, a Mexican-style debt accord would elicit considerable local criticism, especially from economists. But a quick victory over inflation would give Collor the popular and political credits he would need to surmount such opposition.

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Forget last year's hedge fund disasters. Leverage is alive and well in collateralized debt obligations.

Leveraged investing may have taken a public lashing last summer thanks to the dramatic near-collapse of the gun-slinging hedge fund Long-Term Capital Management. But the main attraction of leverage -- enhanced returns -- persists, and investors are pouring into the newest structures designed to maximize yield, while containing, as best they can, risk.

The vehicle of choice: collateralized **debt** obligations. Issuance of these **securities** , which are **backed** by pools of junk bonds or bank **loans** , has simply exploded. In 1995 only $1 billion in rated CDOs were offered. Last year $82 billion were rated and snapped up by gorging investors. And Moody's Investors Service expects issuance to grow by 20 to 30 percent this year.

CDO is a relatively new term for an evolving investment class. Essentially a type of asset-backed security; CDOs pool their collateral in a trust that issues several tranches of securities with tiered seniority, from a top level of highly rated senior debt to a bottom portion of unrated equity, which is the first to lose value if any of the underlying collateral stops paying for any reason. Unlike most other asset-backed securities, CDOs use high-yielding collateral such as junk bonds, leveraged **loans** and emerging-markets bonds to goose their returns. A CDO tranche can yield up to 100 basis points more than comparably rated corporate bonds. Issuers of the securities -- who package and manage the underlying portfolio -- boost yields by buying the underlying collateral on margin.

Such yields don't come without risks, of course, which vary depending on the tranche. The top tranche often carries bond **insurance** and may sport a triple-A rating. Middle tranches are junk-rated. Though none of these midtiers have suffered a default, Moody's downgraded tranches of 20 CDOs in 1998. Almost all of these were CDOs backed by Japanese bank **loans** , but two issues from Credit Suisse First Boston and Credit Suisse Financial Products -- the York Funding and Triangle Funding CDOs -- received lower ratings because of the bank's own downgrade. (The collateral in each issue included credit-linked notes issued by CSFB and CSFP.) Last year Standard & Poor's did not downgrade any of the CDO tranches it rates, because they all had bond **insurance** .

Despite the risks, investors love the yield boost that CDOs offer. "Typically, we like single-A, triple-B, sometimes double-B tranches," says Keith Koh, an investment manager with Principal Capital Management, which has bought CDOs since the market began a decade ago. "We did a study going back to 1994 and it shows that double-B tranches definitely performed 100 basis points over similarly rated corporate bonds." Single-A tranches typically pay 30 to 40 basis points over corporates, he adds.

Money managers can also take advantage of an arbitrage opportunity by structuring CDOs and **selling** the tranches to other investors. Often managers buy bonds and **loans** worth ten times their initial equity investment, borrowing against the collateral pool in a transaction resembling a repurchase agreement. Investors receive the difference between the leveraged collateral payout and the CDO's cost of funding. Even as the debt markets have recovered this year, the spread between B-rated instruments (the typical collateral for a CDO) and double-A corporate debt (comparably rated to a CDO's senior tranche) has reached as much as 500 basis points. That wide spread makes it very easy to effect the arbitrage.

Pacific Investment Management Co. has structured seven CDOs worth a total of nearly $3 billion in the past several years and is working on a new one. The firm earns management fees of about 40 basis points for running the CDO portfolio and sometimes reaps a performance fee of 20 basis points linked to equity holders' returns as well. Pimco keeps its CDOs separate from the bond portfolios it manages for clients, but the firm's huge presence in the bond market puts it in an ideal position to buy bonds and **loans** for CDO collateral.

Money managers like Pimco typically structure CDOs with the help of an investment bank, which underwrites the issue and **sells** the tranches. Buyers typically include endowments, **insurance** companies, alternative asset managers, private clients and, sometimes, other fixed-income managers that are looking for diversification. "There's a much greater acceptance of financial engineering," comments Pimco high-yield product manager David Hinman. "People are more comfortable with synthetic structures."

The fat yield on the investment-grade tranches helps, too. Money market funds and European banks tend to be big buyers. Endowments often select mezzanine and equity pieces; as buy-and-hold investors they can capture the illiquidity premium priced into the less credit-worthy tranches. Funds-of-funds and alternative asset management groups also tend to buy the mezzanine and equity pieces.

The CDO market got under way in the late 1980s with the first collateralized bond obligations, which were sold by troubled thrifts to reduce their junk bond exposure. The collapse of the junk bond market in the early 1990s caused CBO issuance to dwindle. Then, in 1996, National Westminster Bank applied the idea of securitization to its **loan** portfolio, packaging $5 billion in a collateralized **loan** obligation that it sold to a wide range of international investors. The move freed up regulatory capital that had been committed to backing the **loans** ; investors snapped up the securities, which had ratings varying from double-A to triple-B and yielded attractive rates of 8 to 65 basis points over LIBOR.

Even as CLO issues boomed, high-yield debt began to return to favor, spurring the issuance of new CBOs, including many that pooled emerging-markets bonds. Today the CBO and CLO markets are con verging, with managers like Pimco mixing bonds and **loans** , and even emerging-markers debt, in the same structures.

In fact, the market is grappling to some extent with terminology. Most market participants, including Moody's, use CDO as an umbrella term for all these securities. S&P considers CBOs, CLOs and CDOs to be separate products; it thinks of CDOs as hybrids that include both bonds and **loans** .

In any case, CDOs continue to evolve, as money managers fiddle with the best mix of collateral to contend with the three main pitfalls for a portfolio of bonds: default risk, liquidity risk and event risk. Pimco's Hinman argues that it is possible to eliminate the latter two risks by managing CDOs passively, holding **loans** and securities to maturity.

Managing default risk is trickier -- but that's where the right mix of bonds and bank **loans** comes into play. Bank **loans** , for instance, are safer instruments than junk bonds because they have a higher position in the capital structure of companies. By putting a large proportion of **loans** in the CDO collateral pool, the manager can limit the, default risk. Hinman reckons the optimal mix of a CDO today is 70 percent bank **loans** , 20 percent bonds and 5 percent emerging-markets bonds. Five percent is usually in cash, he says. Just a few years ago, most CDOs had a much higher ratio of bonds to bank **loans** -- Hinman's first CDO, in 1996, consisted of 80 percent junk bonds, 10 percent bank **loans** and 10 percent emerging-markers bonds.

Why not **create** funds that are just filled with bank **loans** ? Because junk juices the yield. "The most bang for your buck comes from high-yield bonds," says Anthony Clemente, a senior portfolio manager at Invesco, which plans to launch two new CDOs this year. He points out that bank **loans** , unlike junk bonds, generally don't trade higher than par. "There are certain industry categories, like telecom, oil and gas and some cyclicals, where there is really no upside for bank debt, while there is significant downside." With junk bonds, explains Clemente, "the spread differential is significant." The bonds, he notes, might trade up to 9 points over par. Invesco, notably, actively manages its CDOs, buying and **selling** collateral to achieve the best return. Pimco prefers a buy-and-hold strategy, restocking portfolios when **loans** mature and occasionally **selling** securities to avoid default risk.

Bank **loans** do have drawbacks, though, including a thin secondary market. Because the easiest way to invest in bank **loans** is through the primary market, CDO managers are forced to buy into the prevailing industry trend. Recent bank 'lending, for instance, has concentrated heavily on the telecommunications industry. That means that CDO managers have little choice but to buy into telecom issues. "What you put in the portfolio is partially driven by availability," says Hinman. "The bank **loan** market is a new-issue market."

Some CDO managers, including Pimco, have used emerging-markets bonds to turbocharge their yield. But after last fall's bond market turmoil, rating agencies view emerging-markets far less favorably. "If you put too

many emerging-markets bonds in, the stress tests look horrible," Hinman explains.

S&P structured-finance analyst David Tesher still paints a relatively reassuring picture, however, pointing out that even during the junk bond marker's worst days, CBOs performed relatively well. "If you look back to the early '90s, there were some CBOs that had problems," he recalls. "There were some that generated very poor returns for the equity investors." But, he adds, "I know of no structures where senior note holders have taken a loss."

Leveraging up
Issuance of collateralized debt obligations has rocketed in the last several years

	10 (No of deals) Rated volume
88	1
89	8
90	10
91	4
92	1
93	4
94	3
95	6
96	30
97	62
98	114
99 [*]	154

Source: Moody's Investors Service.
(*.)Projected.

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INDUSTRY NAMES: BANK (Banking, Finance and Accounting); BUSN (Any type of business)
NAICS CODES: 52311 (Investment Banking and Securities Dealing)
SPECIAL FEATURES: LOB

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In fact, the market is grappling...to be separate products; it thinks of CDOs as hybrids that include both bonds and **loans** .

In any case, CDOs continue to evolve, as money managers fiddle with the best mix...

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Managing default risk is trickier -- but that's where the right mix of bonds and bank **loans** comes into play. Bank **loans** , for instance, are safer instruments than junk bonds because they have a higher position in the capital structure of companies. By putting a large proportion of **loans** in the CDO collateral pool, the manager can limit the, default risk. Hinman reckons the optimal mix of a CDO today is 70 percent bank **loans** , 20 percent bonds and 5 percent emerging-markets bonds. Five percent is usually in cash...

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...trade up to 9 points over par. Invesco, notably, actively manages its CDOs, buying and **selling** collateral to achieve the best return. Pimco prefers a buy-and-hold strategy, restocking portfolios when **loans** mature and occasionally **selling** securities to avoid default risk.

Bank **loans** do have drawbacks, though, including a thin secondary market. Because the easiest way to invest in bank **loans** is through the

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19990501

10/K,9/4 (Item 1 from file: 148)

DIALOG(R)File 148:Gale Group Trade & Industry DB

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Much obliged.

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Institutional Investor, 33, 5, 135(1)
May, 1999
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TEXT:

Forget last year's hedge fund disasters. Leverage is alive and well in collateralized debt obligations.

Leveraged investing may have taken a public lashing last summer thanks to the dramatic near-collapse of the gun-slinging hedge fund Long-Term Capital Management. But the main attraction of leverage -- enhanced returns -- persists, and investors are pouring into the newest structures designed to maximize yield, while containing, as best they can, risk.

The vehicle of choice: collateralized **debt** obligations. Issuance of these **securities** , which are **backed** by pools of junk bonds or bank **loans** , has simply exploded. In 1995 only $1 billion in rated CDOs were offered. Last year $82 billion were rated and snapped up by gorging investors. And Moody's Investors Service expects issuance to grow by 20 to 30 percent this year.

CDO is a relatively new term for an evolving investment class. Essentially a type of asset-backed security; CDOs pool their collateral in a trust that issues several tranches of securities with tiered seniority, from a top level of highly rated senior debt to a bottom portion of unrated equity, which is the first to lose value if any of the underlying collateral stops paying for any reason. Unlike most other asset-backed securities, CDOs use high-yielding collateral such as junk bonds, leveraged **loans** and emerging-markets bonds to goose their returns. A CDO tranche can yield up to 100 basis points more than comparably rated corporate bonds. Issuers of the securities -- who package and manage the underlying portfolio -- boost yields by buying the underlying collateral on margin.

Such yields don't come without risks, of course, which vary depending on the tranche. The top tranche often carries bond **insurance** and may sport a triple-A rating. Middle tranches are junk-rated. Though none of these midtiers have suffered a default, Moody's downgraded tranches of 20 CDOs in 1998. Almost all of these were CDOs backed by Japanese bank **loans** , but two issues from Credit Suisse First Boston and Credit Suisse Financial Products -- the York Funding and Triangle Funding CDOs -- received lower ratings because of the bank's own downgrade. (The collateral in each issue included credit-linked notes issued by CSFB and CSFP.) Last year Standard & Poor's did not downgrade any of the CDO tranches it rates, because they all had bond **insurance** .

Despite the risks, investors love the yield boost that CDOs offer. "Typically, we like single-A, triple-B, sometimes double-B tranches," says Keith Koh, an investment manager with Principal Capital Management, which

has bought CDOs since the market began a decade ago. "We did a study going back to 1994 and it shows that double-B tranches definitely performed 100 basis points over similarly rated corporate bonds." Single-A tranches typically pay 30 to 40 basis points over corporates, he adds.

Money managers can also take advantage of an arbitrage opportunity by structuring CDOs and **selling** the tranches to other investors. Often managers buy bonds and **loans** worth ten times their initial equity investment, borrowing against the collateral pool in a transaction resembling a repurchase agreement. Investors receive the difference between the leveraged collateral payout and the CDO's cost of funding. Even as the debt markets have recovered this year, the spread between B-rated instruments (the typical collateral for a CDO) and double-A corporate debt (comparably rated to a CDO's senior tranche) has reached as much as 500 basis points. That wide spread makes it very easy to effect the arbitrage.

Pacific Investment Management Co. has structured seven CDOs worth a total of nearly $3 billion in the past several years and is working on a new one. The firm earns management fees of about 40 basis points for running the CDO portfolio and sometimes reaps a performance fee of 20 basis points linked to equity holders' returns as well. Pimco keeps its CDOs separate from the bond portfolios it manages for clients, but the firm's huge presence in the bond market puts it in an ideal position to buy bonds and **loans** for CDO collateral.

Money managers like Pimco typically structure CDOs with the help of an investment bank, which underwrites the issue and **sells** the tranches. Buyers typically include endowments, **insurance** companies, alternative asset managers, private clients and, sometimes, other fixed-income managers that are looking for diversification. "There's a much greater acceptance of financial engineering," comments Pimco high-yield product manager David Hinman. "People are more comfortable with synthetic structures."

The fat yield on the investment-grade tranches helps, too. Money market funds and European banks tend to be big buyers. Endowments often select mezzanine and equity pieces; as buy-and-hold investors they can capture the illiquidity premium priced into the less credit-worthy tranches. Funds-of-funds and alternative asset management groups also tend to buy the mezzanine and equity pieces.

The CDO market got under way in the late 1980s with the first collateralized bond obligations, which were sold by troubled thrifts to reduce their junk bond exposure. The collapse of the junk bond market in the early 1990s caused CBO issuance to dwindle. Then, in 1996, National Westminster Bank applied the idea of securitization to its **loan** portfolio, packaging $5 billion in a collateralized **loan** obligation that it sold to a wide range of international investors. The move freed up regulatory capital that had been committed to backing the **loans** ; investors snapped up the securities, which had ratings varying from double-A to triple-B and yielded attractive rates of 8 to 65 basis points over LIBOR.

Even as CLO issues boomed, high-yield debt began to return to favor, spurring the issuance of new CBOs, including many that pooled emerging-markets bonds. Today the CBO and CLO markets are con verging, with managers like Pimco mixing bonds and **loans** , and even emerging-markers debt, in the same structures.

In fact, the market is grappling to some extent with terminology. Most market participants, including Moody's, use CDO as an umbrella term for all these securities. S&P considers CBOs, CLOs and CDOs to be separate products; it thinks of CDOs as hybrids that include both bonds and **loans** .

In any case, CDOs continue to evolve, as money managers fiddle with the best mix of collateral to contend with the three main pitfalls for a portfolio of bonds: default risk, liquidity risk and event risk. Pimco's Hinman argues that it is possible to eliminate the latter two risks by managing CDOs passively, holding **loans** and securities to maturity.

Managing default risk is trickier -- but that's where the right mix of bonds and bank **loans** comes into play. Bank **loans** , for instance, are safer instruments than junk bonds because they have a higher position in the capital structure of companies. By putting a large proportion of **loans** in the CDO collateral pool, the manager can limit the, default risk. Hinman reckons the optimal mix of a CDO today is 70 percent bank **loans** , 20 percent bonds and 5 percent emerging-markets bonds. Five percent is usually in cash, he says. Just a few years ago, most CDOs had a much higher ratio of bonds to bank **loans** -- Hinman's first CDO, in 1996, consisted of 80 percent junk bonds, 10 percent bank **loans** and 10 percent emerging-markers bonds.

Why not **create** funds that are just filled with bank **loans** ? Because junk juices the yield. "The most bang for your buck comes from high-yield bonds," says Anthony Clemente, a senior portfolio manager at Invesco, which plans to launch two new CDOs this year. He points out that bank **loans** , unlike junk bonds, generally don't trade higher than par. "There are certain industry categories, like telecom, oil and gas and some cyclicals, where there is really no upside for bank debt, while there is significant downside." With junk bonds, explains Clemente, "the spread differential is significant." The bonds, he notes, might trade up to 9 points over par. Invesco, notably, actively manages its CDOs, buying and **selling** collateral to achieve the best return. Pimco prefers a buy-and-hold strategy, restocking portfolios when **loans** mature and occasionally **selling** securities to avoid default risk.

Bank **loans** do have drawbacks, though, including a thin secondary market. Because the easiest way to invest in bank **loans** is through the primary market, CDO managers are forced to buy into the prevailing industry trend. Recent bank 'lending, for instance, has concentrated heavily on the telecommunications industry. That means that CDO managers have little choice but to buy into telecom issues. "What you put in the portfolio is partially driven by availability," says Hinman. "The bank **loan** market is a new-issue market."

Some CDO managers, including Pimco, have used emerging-markets bonds to turbocharge their yield. But after last fall's bond market turmoil, rating agencies view emerging-markets far less favorably. "If you put too many emerging-markets bonds in, the stress tests look horrible," Hinman explains.

S&P structured-finance analyst David Tesher still paints a relatively reassuring picture, however, pointing out that even during the junk bond marker's worst days, CBOs performed relatively well. "If you look back to the early '90s, there were some CBOs that had problems," he recalls. "There were some that generated very poor returns for the equity investors." But, he adds, "I know of no structures where senior note holders have taken a loss."

Leveraging up

Issuance of collateralized debt obligations has rocketed in the last several years

	10 (No of deals) Rated volume
88	1
89	8
90	10
91	4
92	1
93	4
94	3
95	6
96	30

97	62
98	114
99 (*)	154

Source: Moody's Investors Service.
(*.)Projected.

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DESCRIPTORS: Securities industry--Statistics; Credit market--Statistics
GEOGRAPHIC CODES/NAMES: 1USA United States
PRODUCT/INDUSTRY NAMES: 6211000 (Securities Dealers)
EVENT CODES/NAMES: 600 Market information - general
NAICS CODES: 52311 Investment Banking and Securities Dealing
FILE SEGMENT: MC File 75

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